# MANAGEMENT'S DISCUSSION AND ANALYSIS—

Required Supplementary Information (Unaudited)

### Management's Discussion and Analysis

In this section of the State of South Carolina's annual report, we provide a narrative overview and analysis of the State's financial performance for its accounting year (*fiscal year*) that ended June 30, 2005. Please read it together with (1) the Comptroller's *Letter of Transmittal* at the front of this report and (2) the financial statements, which follow this section.

#### Overview of the Financial Statements

This discussion and analysis provides an introduction to the State of South Carolina's basic financial statements, which include the following parts: (1) government-wide financial statements, (2) fund financial statements, (3) component unit financial statements, and (4) notes to the financial statements. This annual report also contains certain required supplementary information and other supplementary information.

#### **Government-wide Financial Statements**

The government-wide statements present a long-term view of the State's finances as a whole, using accrual-basis accounting—the same accounting methods that most businesses use. The basic government-wide financial statements are on pages 36 through 41 of this report.

There are two government-wide financial statements:

<u>Statement of net assets</u>: This statement presents information on *all* of the State's assets and liabilities, both short-term (*current*) and long-term (*non-current*). In addition, the statement reports the difference between assets and liabilities as *net assets*. Over time, the comparison of net assets to liabilities may indicate whether the State's financial health is strengthening or weakening. However, the statement of net assets does not tell the whole story. To assess the State's overall financial health, you would also need to consider factors such as the State's economy and the condition of its *capital assets* such as its buildings and *infrastructure* (roads and bridges).

<u>Statement of activities</u>: This statement presents information showing how the State's overall net assets changed during the year. The State reports a change in its net assets as soon as an underlying event occurs that would cause a change. The statement of activities accounts for all current-year revenues and expenses, regardless of when the State received or paid cash. Although governments compile the statement of activities using accounting methods similar to businesses, this statement's format is quite different from the format of a business's income statement. The statement of activities can help to show how much it costs the State to provide various services. It also can help to show the extent to which each government function covers its own costs through user fees, charges, or grants. The net *revenue (expense)* column on the far right of this statement (page 40) shows how much a particular function relies on taxes and other general revenues to finance its programs.

The government-wide statements report three different kinds of *activities*:

<u>Governmental activities</u>: Most of the State's basic services are included here, such as general government, education, health and environment, social services, administration of justice, and intergovernmental (State aid to local governmental entities, including aid to the State's public school system). Taxes (primarily income and sales taxes) and federal grants finance most of these services.

<u>Business-type activities</u>: These activities usually recover all, or a significant portion, of the costs of their services or goods by charging fees to customers. Higher education (State-supported colleges and universities), unemployment compensation benefits, financing of housing facilities, operating hospitals and clinics, and financing of student loans are the most significant of South Carolina's business-type activities.

<u>Component units</u>: Although component units are legally separate from the State, the State's elected officials are financially accountable for them. The Public Service Authority (Santee-Cooper, an electric utility company), the State Ports Authority, the Connector 2000 Association, Inc. (which operates the Southern Connector, a toll road), and the Lottery Commission are the State's major component units. Some financial information for these component units is included in this report. You also can obtain complete financial statements for these component units from their respective administrative offices (see Note 1a of the notes to the financial statements).

#### **Fund Financial Statements**

The fund financial statements on pages 42 through 65 of this report provide detailed information about the State's most significant funds—not the State as a whole. Funds are accounting designations that the State uses to track specific funding sources and spending for particular purposes. South Carolina, like other governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The State reports three types of *funds*:

<u>Governmental funds</u>: The State reports most of its basic services in governmental funds. Governmental funds account for activities that the State reports as *governmental activities* in its government-wide statements. These funds focus on *short-term* inflows and outflows of expendable resources. The balances remaining at the end of the year help determine whether a fund has more or less financial resources available to spend in the near future. Because the governmental fund statements lack the additional long-term focus of the government-wide statements, we provide a reconciliation that explains the relationship (or differences) between the two kinds of statements. By comparing the two kinds of statements and examining the reconciliation, you may better understand the long-term impact of the State's near-term financing decisions.

The basic governmental fund statements are on pages 42 through 49 of this report.

<u>Proprietary funds</u>: Proprietary funds charge customers for the services they provide—whether they are outside customers (<u>enterprise funds</u>) or other State agencies and other governments (<u>internal service funds</u>). Proprietary funds use <u>accrual basis accounting</u> like businesses use. The State reports all of its enterprise funds (proprietary funds providing services to outside customers) as <u>business-type activities</u> in the government-wide statements. However, because our internal service fund operations primarily benefit other State agencies or other governments, these proprietary funds are included as <u>governmental activities</u> in the government-wide financial statements.

The basic proprietary fund statements are on pages 50 through 63 of this report.

<u>Fiduciary funds</u>: The State is the trustee, or <u>fiduciary</u>, for its employees' retirement plans. The State also is responsible for other assets that, because of a trust agreement, it is to use only for trust beneficiaries. We <u>exclude</u> these activities from the State's government-wide financial statements because the State is not to use these assets to finance its operations. The State has an obligation to ensure that the net assets it reports in fiduciary funds are used for their intended purposes.

The basic fiduciary fund statements are on pages 64 and 65 of this report.

#### **Component Unit Financial Statements**

The *Government-wide Financial Statements* section on the preceding page lists the State's major component units under the *Component units* subheading. More detailed financial statements for these component units are on pages 66 through 69 of this report.

#### **Notes to the Financial Statements**

Immediately following the financial statements are *notes* that help explain some of the information in the financial statements and provide more detailed data. The notes on pages 73 through 138 are necessary to fully understand the financial statements.

#### **Required Supplementary Information**

This section includes certain *required* reporting information that supplements the basic financial statements. Included in this section is a schedule that compares the State's legally adopted General Fund budget with actual revenues collected and expenditures paid for the year. Note 5 to the required supplementary information is a reconciliation that helps explain differences between the changes in fund balance of certain funds when presented on the budgetary-basis and the changes in fund balance of these funds when presented on the GAAP-basis as reported in the governmental fund statements. This section also includes schedules related to the State's National Guard Pension System, a single-employer defined benefit pension plan. This required supplementary information is on pages 140 through 147of this report.

#### **Government-wide Financial Analysis**

Exhibits 1 and 2 summarize the State's overall financial position and results of operations for the past two years based on information included in the government-wide financial statements.

## Exhibit 1 State of South Carolina's Net Assets As of June 30, 2005, with Restated Comparative Data as of June 30, 2004 (Expressed in Thousands)

	Govern Acti	nmen vities			Busine Acti	ss-ty	•		Tota Primary G	Total Percentage Change	
<del>-</del>	2005		2004		2005		2004		2005	2004	2004-2005
Assets								_			
Current and other assets\$	7,632,230	\$	6,491,260	\$	4,561,239	\$	3,768,061	\$	12,193,469	\$ 10,259,321	18.9%
Capital assets	12,360,919		11,670,170		2,823,300		2,589,266		15,184,219	14,259,436	6.5%
Total assets	19,993,149		18,161,430		7,384,539		6,357,327		27,377,688	24,518,757	11.7%
Liabilities											
Long-term liabilities	5,122,938		4,893,936		3,135,539		2,375,252		8,258,477	7,269,188	13.6%
Other liabilities	3,429,415		3,113,596		882,346		829,529		4,311,761	3,943,125	9.3%
Total liabilities	8,552,353		8,007,532		4,017,885		3,204,781		12,570,238	11,212,313	12.1%
Net Assets											
Invested in capital assets, net of debt	8,877,813		8,534,931		1,778,072		1,695,208		10,655,885	10,230,139	4.2%
Restricted	2,735,158		2,568,996		1,228,545		1,186,958		3,963,703	3,755,954	5.5%
Unrestricted	(172,175)		(950,029)		360,037		270,380		187,862	(679,649)	127.6%
Total net assets	11,440,796	\$	10,153,898	\$	3,366,654	\$	3,152,546	\$	14,807,450	\$ 13,306,444	11.3%

#### **Net Assets**

As we noted earlier, the comparison of net assets to liabilities may serve, over time, as a useful indicator of the State's financial strength. At the end of the 2004-2005 accounting year, the State's net assets totaled \$14.807 billion.

The largest portion of the State's net assets reflects its investment in capital assets (for example, buildings, roads, and bridges), less any related debt used to acquire those assets that is still outstanding. The State uses these capital assets to provide services to citizens; consequently, they are *not* available for future spending. Further, the State cannot sell the capital assets themselves to pay off the related debt because it needs the assets for its operations; so it must find other resources to pay off the debt.

Restricted net assets generally are available for future spending but are subject to external restrictions, such as bond covenants, federal government grant restrictions, or restrictions imposed by enabling State legislation or through State constitutional provisions. The State's largest restricted balances include capital improvement bond proceeds (restricted for various capital projects), and loan program funds (restricted primarily for local government water and sewer projects).

Unrestricted net assets—resources available for future spending—reported a balance of \$187.862 million at June 30, 2005. This represents an improvement of \$867.511 million over the prior year. The majority of this improvement resulted from a \$777.854 million increase in the net assets reported for the State's governmental activities, which reported a negative \$172.175 million in unrestricted net assets for the current fiscal year versus a negative \$950.029 million balance in the prior year. This substantial improvement occurred primarily because of significant increases in fund balances for the State's General and Departmental General Operating funds, which are considered unrestricted for government-wide reporting. The State is governmental activities have recently reported negative unrestricted net asset balances due in large part from the State issuing long-term debt (a liability) to finance capital assets for local governments (such as for school facilities). In such instances, the State records significant liabilities, which reduce unrestricted net assets, but does not record the related capital assets because they belong to the local governments. Please see Note 3 in the notes to the financial statements for a more detailed explanation of the deficit reported for the State's governmental activities.

The State's *business-type activities*, on the other hand, reported a *positive* \$360.037 million unrestricted net asset balance. This resulted from net positive balances of \$574.450 million associated with higher education and certain other business-type activities. However, that positive balance was offset by a \$214.413 million deficit related to the State-run medical malpractice insurance program.

Exhibit 2

State of South Carolina's Changes in Net Assets

For the Fiscal Year Ended June 30, 2005, with Restated Comparative Data for the Fiscal Year Ended June 30, 2004

(Expressed in Thousands)

	Governmental Activities					Busine Acti	ess-typ	e	Tot Primary G	Total Percentage Change	
		2005		2004		2005		2004	2005	 2004	2004-2005
Revenues											
Program revenues:											
Charges for services		1,816,591	\$	1,610,779	\$	3,173,818	\$	3,010,024	\$ 4,990,409	\$ 4,620,803	8.0%
Operating grants and contributions		6,052,454		5,656,373		419,672		422,971	6,472,126	6,079,344	6.5%
Capital grants and contributions		650,384		708,685		55,166		47,136	705,550	755,821	(6.7%)
General revenues:											
Individual income tax		2,762,538		2,416,437		_		_	2,762,538	2,416,437	14.3%
Retail sales and use tax		3,221,466		3,009,485		_		_	3,221,466	3,009,485	7.0%
Other taxes		1,469,701		1,390,893		_		_	1,469,701	1,390,893	5.7%
Unrestricted grants and contributions		26,391		80,333		_		_	26,391	80,333	(67.1%)
Unrestricted investment income		32.628		18,723		_		_	32.628	18.723	74.3%
Tobacco legal settlement		73,231		74,180		_		_	73,231	74,180	(1.3%)
Other		71,090		75,967		_		_	71,090	75,967	(6.4%)
Total revenues		16,176,474		15,041,855		3,648,656	_	3,480,131	 19,825,130	 18,521,986	7.0%
Expenses											
Governmental activities:											
General government		1,727,612		1,587,442		_		_	1,727,612	1,587,442	8.8%
Education		1,280,791		1,228,354		_		_	1,280,791	1,228,354	4.3%
Health and environment		4,767,155		4,588,137		_		_	4,767,155	4,588,137	3.9%
Social services		992,960		942,591		_		_	992,960	942,591	5.3%
Administration of justice		629,185		628,227		_		_	629,185	628,227	0.2%
Resources and economic development		197,351		192,000		_		_	197,351	192,000	2.8%
Transportation		664,125		531,667		_		_	664,125	531,667	24.9%
Intergovernmental		3,848,454		3,813,383		_		_	3,848,454	3,813,383	0.9%
Other		67.705		67,614		_		_	67.705	67.614	0.1%
Business-type activities:											
Higher education		_		_		2.679.238		2.527.649	2.679.238	2.527.649	6.0%
Higher education institution support a		_		_		800,151		757,252	800.151	757,252	5.7%
Unemployment compensation benefits		_		_		366.820		493,619	366.820	493,619	(25.7%)
Financing of housing facilities		_		_		147,021		137,671	147,021	137,671	6.8%
Medical malpractice insurance						47.432		30.733	47,432	30.733	54.3%
Financing of student loans						43,567		39,641	43,567	39,641	9.9%
Tuition prepayment program		_		_		26,653		30,620	26,653	30,620	(13.0%)
Patriots Point development		_		_		6,638		6.976	6,638	6,976	(4.8%)
Insurance claims processing		_		_		1,655		1,586	1,655	1,586	4.4%
		_		_							
Other		- 44475 000	_	40.570.445		29,055		22,659	 29,055	 22,659	28.2%
Total expenses		14,175,338		13,579,415		4,148,230	_	4,048,406	18,323,568	 17,627,821	3.9%
Excess (deficiency) before											
transfers and extraordinary items		2,001,136		1,462,440		(499,574)		(568,275)	1,501,562	894.165	67.9%
		2,001,136		1,402,440		,					
Extraordinary items		-		- (200 545)		(556)		(773)	(556)	(773)	28.1%
Net transfers		(714,238)		(668,515)		714,238		668,515	 	 <del></del>	N/A
Increase in net assets		1,286,898		793,925		214,108		99,467	1,501,006	893,392	68.0%
Net assets, beginning of year (restated)		10,153,898		9,359,973		3,152,546		3,053,079	 13,306,444	 12,413,052	7.2%
Net assets, end of year	\$	11,440,796	\$	10,153,898	\$	3,366,654	\$	3,152,546	\$ 14,807,450	\$ 13,306,444	11.3%

<sup>&</sup>lt;sup>a</sup> The higher education institution support activity represents certain associations, foundations, and authorities created for the benefit of the State's higher education institutions.

#### **Changes in Net Assets**

The State's net assets increased \$1.501 billion, or 11.3%, over the prior year's net assets.

#### **Governmental Activities**

Net assets of the State's governmental activities increased by \$1.287 billion, or 12.7%, primarily due to increased revenues. Governmental activities' revenues are derived mostly from taxes; grants and contributions, including federal aid; and charges for goods and services. *Exhibit 3* illustrates the sources of revenues that support governmental activities.

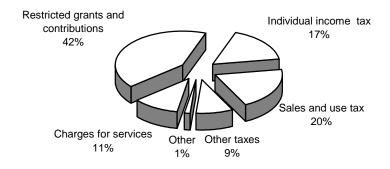
Governmental activities' expenses were mostly associated with services provided for health and environment, intergovernmental, general government, education, and social services. *Exhibit 4* compares the cost of these services with their *program revenues*—revenues derived directly from the program itself or from parties outside the State's taxpayers or citizenry. The difference between the two represents the *net cost* of these services that taxes and other general revenues financed. Intergovernmental expenses of \$3.848 billion represent aid provided to local governments, including local school districts; taxes and other general revenues entirely supported these expenses. This aid includes formula-based State revenue sharing, aid to local school districts for public education, and subsidies to reimburse counties for the State's residential property tax relief program. For the accounting year ended June 30, 2005, the State used \$7.657 billion in tax and other general revenues to finance the net cost of all services that the State's governmental activities provided. Governmental activities reported \$714.238 million in net transfers to the State's business-type activities, most of which represents support provided to the State's public colleges and universities.

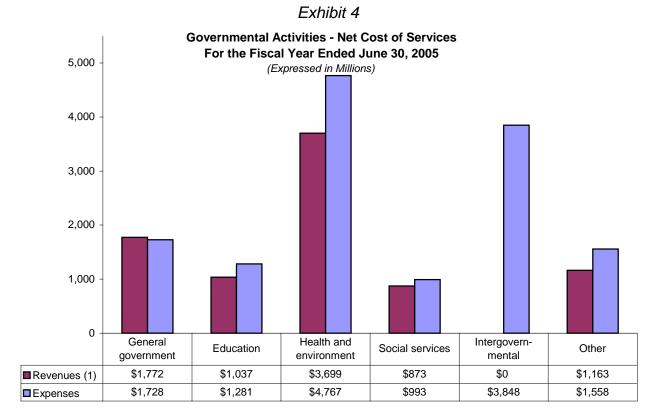
The following paragraphs highlight the most significant changes in revenues, expenses, and net transfers for governmental activities during the 2004-2005 accounting year:

- Charges for services grew by \$205.812 million, or 12.8%, primarily because two of the State's internal service funds, the Employee Insurance Programs and the Insurance Reserve Fund, increased premiums to subscribers.
- Operating grants and contracts increased \$396.081 million, or 7.0%, over last year. Most of this increase is attributable
  to federal funding for Medicaid and food stamp benefits. Additional federal funding was received for election
  administration improvements and for homeland security.
- Capital grants and contributions decreased \$58.301 million, or 8.2%, because of less federal funding for State highway construction projects.
- State tax revenues rebounded due to increased tax enforcement collections and improving economic conditions. Tax revenues increased \$636.890 million, or 9.3%, over last year. Individual income and sales taxes increased 14.3% and 7.0%, respectively, as the State's employment picture improved. Also, tax enforcement collections increased significantly due to the hiring of additional tax auditors.
- Unrestricted grants and contributions were \$53.942 million, or 67.2%, less than the prior year. Last year included the second and final payment of \$62.295 million from the Federal government under the Jobs and Growth Tax Relief Reconciliation Act of 2003.
- Transportation expenses rose \$132.458 million, or 24.9%, because of an increase in highway construction and maintenance projects.

Exhibit 3

Revenues Supporting Governmental Activities - By Source
For the Fiscal Year Ended June 30, 2005





(1) Derived directly from program itself or from parties outside the State's taxpayers or citizenry.

#### **Business-type Activities**

Net assets of the State's business-type activities increased \$214.108 million, or 6.8%.

Revenues from business-type activities included charges for services (87.0%) and grants and contributions (including federal aid) (13.0%). Expenses from business-type activities were mostly to provide higher education services and support (83.9%), unemployment compensation benefits (8.8%), and financing of housing facilities (3.5%).

Most business-type activities are self-supporting. Tuition and student fees, research and other grants (both private and governmental), and other charges primarily pay for the services that the Higher Education Fund provides. However, the Higher Education Fund receives substantial resources (primarily transfers of annual appropriations) from the State's governmental activities. Essentially, net transfers to the Higher Education Fund represent the cost of educational services that taxes and other general revenues of governmental activities support.

The following paragraphs highlight the most significant changes in revenues, expenses, and net transfers for business-type activities during the 2004-2005 accounting year:

- Charges for services increased \$163.794 million, or 5.4%. This was primarily because of increases for higher education
  activities. Revenues of State-supported colleges and universities increased because of higher tuition and student fees as
  well as from increased enrollment. Higher education revenues also increased because of lottery-funded scholarships to
  in-State students who met certain requirements.
- Higher education and support expenses increased \$194.488 million, or 7.7%. This increase resulted primarily from
  increases in compensation and benefits, services and supplies, and utilities. Higher utility expenses resulted from a
  combination of rate increases and the addition of major capital buildings. Other increases are the result of growth in both
  research and institutional programs.
- Unemployment compensation benefit expenses declined \$126.799 million, or 25.7%, primarily due to ending the Emergency Unemployment Compensation program in the prior year and improved economic conditions.

#### Financial Analysis of the State's Funds

The State of South Carolina uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. Within the fund financial statements, the focus is on reporting major funds.

#### **Governmental Funds**

Exhibit 5 shows the components of fund balance for the State's various governmental funds as of June 30, 2005.

Exhibit 5
State of South Carolina's Governmental Fund Balances
(Expressed in Thousands)

_	General Fund	Departmental General Operating		Local overnment rastructure	Tra	partment of nsportation cial Revenue	State Fobacco ettlement	lonmajor vernmental Funds	Total Governmental Funds		
Reserved\$ Unreserved, designated Unreserved, undesignated	142,662 345,437 —	\$ 578 — 489,562	\$	1,759,771 — (269,231)	\$	7,579 — 49,217	\$ — — 490,641	\$ 174,333 199,010 450,077	\$	2,084,923 544,447 1,210,266	
Totals\$	488,099	\$ 490,140	\$	1,490,540	\$	56,796	\$ 490,641	\$ 823,420	\$	3,839,636	
Change from prior year \$	479,140	\$ 151,488	\$	77,820	\$	103,895	\$ (8,230)	\$ (60,455)	\$	743,658	
Percentage change	5,348.1%	44.7%		5.5%		220.6%	(1.6%)	(6.8%)		24.0%	

At June 30, 2005, total ending fund balance for the State's governmental funds was \$3.840 billion, which represents an increase of \$743.658 million, or 24.0%, from the prior year. About half of this total (45.7%) makes up the *unreserved* fund balance—the amount available for spending in the coming year. The remaining fund balance is *reserved* and is *not* available for future appropriation because it is accessible only for specific purposes. The following paragraphs discuss the major governmental funds that had significant changes in fund balance:

The General Fund is one of two large State operating funds. This fund includes resources that pay for the services that the State traditionally has provided to its citizens. These resources, such as taxes, are accounted for in the General Fund unless State law requires them to be accounted for in another fund. During the 2004-2005 accounting year, the total fund balance of the General Fund increased \$479.140 million over last year. This is consistent with a \$517.866 million operating surplus reported for the State's budgetary-basis General Fund. The increase was due to a combination of improved economic conditions and conservative budgeting. Total revenues grew \$525.836 million, or 8.6%, while expenditures increased by only \$78.491 million, or 1.5%. The fund's two major revenue sources saw significant growth compared to the prior year. Individual income taxes increased \$356,022 million, or 14.8%, while sales and use taxes increased \$144,338 million, or 6.6%. In addition to an improved economy, the State stepped up its efforts to collect taxes by hiring additional tax auditors. As a result, enforced tax collections increased significantly over the prior year. Federal revenues, although not a major source for this fund, declined by \$58.349 million, or 32.3%, from prior year levels. This relates to unrestricted grants funds received last year under the Federal Jobs and Growth Tax Relief Reconciliation Act of 2003 that are no longer applicable. General Fund expenditures grew at a much slower rate than revenues because of a budget policy that limited growth during the fiscal year. Expenditure growth was nominal for most of the State's functional categories. The greatest increase was in health and environment expenditures, which were up \$120.576 million or 8.6%. This increase was attributable to growth in the State's share of matching funds associated with the Federal Medicaid assistance program. Medicaid expenditures continue to rise each year due to the spiraling cost of healthcare and prescription drugs. Educational expenditures actually decreased during the year by \$76.511 million or 23.6% because the South Carolina Education Lottery Commission began funding certain higher educational scholarships that had been appropriated previously from the General Fund.

The Departmental General Operating Fund accounts for resources, other than General Fund resources, that State agencies may use for operating purposes. These resources include significant amounts of Federal grant receipts. Fund balance increased \$151.488 million, or 44.7%, over last year. Total revenues increased 7.8% over last year. Contributions revenue increased \$124.291 million, or 70.5%, as a result of approximately \$109.000 million more in Medicaid matching funds received from public hospitals this year. Total expenditures increased by 7.1%. Expenditures for general government and social services increased significantly. Social service expenditures increased \$119.456 million, or 15.1%, primarily because of an increase in food stamp benefits. General government expenditures increased by \$63.337 million, or 41.4%, for several reasons. The State's Office on Aging was moved from the State's Department of Health and Human Services to the Lieutenant Governor's Office under government restructuring legislation, and there were additional expenditures for projects at the Department of Motor Vehicles. Net transfers into the fund created the greatest increase in fund balance. Net transfers

in were \$74.193 million, or 143.5% greater than last year, partly because of the receipt this year of economic development bond proceeds for authorized projects at the Department of Commerce and because of a large one-time transfer out in the prior year of unrestricted grant proceeds.

The Department of Transportation (DOT) Special Revenue Fund accounts for various gasoline taxes, fees, fines, and federal grant resources. The DOT uses these resources to pay for its general operations, which include maintenance, regulation, and construction of public highways and bridges. Fund balance increased \$103.895 million during 2004-2005 resulting in a positive total fund balance of \$56.796 million at the end of the fiscal year. This increase resulted from increased Federal highway funding and approximately \$146.495 million in bond proceeds to fund new road and bridge infrastructure projects.

#### **Proprietary Funds**

Exhibit 6 shows the components of net assets for the State's various proprietary funds at June 30, 2005.

Exhibit 6
State of South Carolina's Proprietary Fund Net Assets
(Expressed in Thousands)

	Enterprise Funds														
Fund Net Assets		Higher Education		mployment	Housing Authority			Medical Iniversity Hospital Authority	A	ducation ssistance Authority	Nonmajor Enterprise			Total Enterprise	Internal Service Funds
Invested in capital assets (net of related debt)	\$	1,701,387 273,007 53,189 415,284	\$	 396,205  	\$	853 240,166 — 2,874	\$	35,746 71,189 — 93,565	\$	240 128,619 — 1,077	\$	39,846 42,741 23,429 (156,415)	\$	1,778,072 1,151,927 76,618 356,385	\$ 122,160 20,000 406 (42,409)
Totals	\$	2,442,867	\$	396,205	\$	243,893	\$	200,500	\$	129,936	\$	(50,399)	\$	3,363,002	\$ 100,157
Change from prior year	\$	171,333	\$	(34,867)	\$	8,864	\$	20,336	\$	5,477	\$	23,683	\$	194,826	\$ 83,028
Percentage change		7.5%		(8.1%)		3.8%		11.3%		4.4%		(32.0%)	_	6.1%	484.7%

The State has two kinds of proprietary funds: enterprise funds and internal service funds.

*Enterprise funds* are reported as business-type activities in the government-wide financial statements. Enterprise funds sell goods or services primarily to parties outside of State government.

The *Higher Education Fund*, an enterprise fund, accounts for the general operations of ten four-year higher education institutions and sixteen area technical colleges. Fund net assets increased \$171.333 million, or 7.5%. The increase is attributed primarily to increases in tuition and student fees, and an increase in grants and contracts from both Federal and State governments.

The *Unemployment Compensation Fund*, an enterprise fund, experienced a decline in fund balance during the accounting year ended June 30, 2005. This fund collects assessments from employers and uses these resources to pay benefits to unemployed persons who are legally eligible to receive such benefits. The fund's net assets decreased \$34.867 million, or 8.1%. Total revenue declined by \$49.412 million primarily due to the end of the Federal Emergency Unemployment Compensation Program in the prior fiscal year. Unemployment compensation benefits paid during the fiscal year were \$126.972 million less than last year due to ending the Emergency Unemployment Compensation program in the prior year and improving economic conditions. Net assets declined, however, because unemployment benefit payments exceeded the insurance premiums and program revenues received.

The *Medical University Hospital Authority*, another enterprise fund, manages and operates the hospitals and clinics associated with the Medical University of South Carolina (MUSC). MUSC is included in the *Higher Education Fund* described above. The Authority's net assets increased \$20.336 million, or 11.3%, primarily due to increases in patient activity and increases in charges for services provided. The Authority became a major enterprise fund this year because of this increased activity and its issuance of revenue bonds to build new facilities.

South Carolina's *internal service funds* provide certain services (including maintenance, insurance, printing, data processing, and motor pool services) and some goods (such as office supplies) primarily to other State funds but sometimes to

local governments as well. The objective of an internal service fund is to charge its customers for the costs of the services or goods that it provides. Because internal service funds primarily benefit State government, South Carolina reports them as governmental activities in the government-wide financial statements.

#### **Budgetary General Fund Highlights**

The State's *Board of Economic Advisors (BEA)* is responsible for forecasting revenues for the budget. State law requires that the BEA meet at least quarterly to review revenue collections and to adjust its forecasts if necessary. If the BEA reduces revenue projections significantly once the budget year begins, the State's *Budget and Control Board* is responsible for mandating spending cuts to keep the budget in balance.

During the fiscal year, the BEA increased its revenue estimate by a total of \$286.877 million for the Budgetary General Fund. The increases occurred over a period of six months as the BEA examined current-year and prior-year revenue collection trends. Tax revenue collections were greater than expected as economic conditions improved and enforcement efforts were stepped up.

The 2004-2005 appropriations had to be increased by \$4.975 million during the year to fund certain State-mandated programs that were underestimated in the Appropriation Act. The State Treasurer's Office received \$4.905 million of these additional appropriations for aid to fire districts in accordance with formula funding.

Actual revenues at June 30, 2005, were \$122.302 million more than even the revised expected revenues. Furthermore, actual revenues were \$517.866 million greater than actual expenditures. Because of reasons previously stated and limited increases in agency spending, the State was able to end the year with an accumulated budgetary general fund surplus of \$533.365 million after giving effect to a one-time adjustment in the amount of \$104.934 million to correct errors in recording revenues in prior fiscal years. Also, an additional \$50.000 million was restored to the State's "rainy day account" bringing the balance in the reserve to \$75.155 million at June 30, 2005.

See the *Budgetary Reporting* subsection of the *Required Supplementary Information* section on pages 140 through 145 of this report for a detailed budgetary comparison schedule.

#### **Capital Assets and Debt Administration**

#### **Capital Assets**

At the end of the 2004-2005 accounting year, the State had \$15.184 billion invested in capital assets. This represented a net increase (including additions and deductions) of \$924.783 million, or 6.5%, over the previous accounting year (see *Exhibit 7*).

Exhibit 7
State of South Carolina's Capital Assets
As of June 30 for the Years Indicated
(Net of Depreciation, Expressed in Thousands,

	Governmental Activities					Busine Acti	ре		Totals—Prima	Total Percentage Change			
		2005	2004		2005		2004		2005		2004		2004-2005
Land and improvements	\$	1,459,853	\$	1,366,894	\$	209,351	\$	204,828	\$	1,669,204	\$	1,571,722	6.2%
Infrastructure		5,883,421		5,775,804		_		_		5,883,421		5,775,804	1.9%
Buildings and improvements		903,596		910,181		1,967,494		1,774,445		2,871,090		2,684,626	6.9%
Vehicles		155,218		163,472		12,358		10,575		167,576		174,047	(3.7%)
Machinery and equipment		116,606		110,642		205,489		202,328		322,095		312,970	2.9%
Works of art and historical treasures		3,712		3,667		19,746		18,913		23,458		22,580	3.9%
Construction in progress		3,833,664		3,326,648		404,255		373,483		4,237,919		3,700,131	14.5%
Intangible assets		4,849		12,862		4,607		4,694		9,456		17,556	(46.1%)
Total	\$	12,360,919	\$	11,670,170	\$	2,823,300	\$	2,589,266	\$	15,184,219	\$	14,259,436	6.5%

Construction in progress at the Department of Transportation increased \$695.281 million over the prior accounting year because of increased Federal funding for highway projects.

As in the previous accounting year, intangible assets decreased primarily because of depreciation expense on the Department of Motor Vehicle's Project Phoenix software system.

See Note 7 in the notes to the financial statements within this report for additional information on the State's capital assets.

#### Long-term Debt

At the end of the accounting year, the State had \$6.932 billion in bonds and notes outstanding—an increase of \$964.106 million, or 13.9%, over last year (see *Exhibit 8*). Note 12, in the notes to the financial statements, includes more detailed information about the State's long-term debt.

Exhibit 8

State of South Carolina's Outstanding Bonds and Notes
As of June 30 for the Years Indicated

(Expressed in Thousands)

		Gover Acti	nmer vities		Busine Acti	ess-t	•	7	Гotals—Prima	Percentage Change	
		2005		2004	2005		2004		2005	2004	2004-2005
Backed by the State:											
General obligation bonds	\$	2,298,253	\$	2,266,261	\$ 230,423	\$	242,740	\$	2,528,676	\$ 2,509,001	0.8%
Backed by specific revenues:											
Revenue bonds and notes		33,832		33,686	2,536,112		1,750,104		2,569,944	1,783,790	44.1%
Infrastructure Bank bonds		1,947,393		1,725,514	_		_		1,947,393	1,725,514	12.9%
Tobacco Authority bonds		820,905		845,630	_		_		820,905	845,630	(2.9%)
Limited obligation bonds		19,392		23,304	_		_		19,392	23,304	(16.8%)
Bond anticipation notes		_		_	9,345		44,310		9,345	44,310	(78.9%)
Total	\$	5,119,775	\$	4,894,395	\$ 2,775,880	\$	2,037,154	\$	7,895,655	\$ 6,931,549	13.9%

New debt resulted mainly from the issuance of revenue bonds by the *enterprise funds* reported in the business-type activities. The Medical University Hospital Authority issued \$483.060 million in revenue bonds primarily to fund new construction while the Housing Authority issued \$181.720 million in bonds for housing programs. The Education Assistance Authority issued \$174.700 million in bonds primarily to provide financing for student loans.

Three bond rating services assign ratings to bonds that the State backs with its own taxing authority (*general obligation bonds*). Standard & Poor's and Fitch Ratings rated these bonds as "AAA," and Moody's Investors Service rated them as "Aaa" during the fiscal year ended June 30, 2005. These are the highest ratings that these services assign. In July 2005, Standard & Poor's downgraded the State's rating to "AA+", citing the State's high unemployment rate and sluggish economic growth following the recession.

The State limits the amount of annual payments for principal and interest on general obligation bonds and notes rather than directly limiting the amount of those bonds and notes that the State may have outstanding. At June 30, 2005, the State legally could issue additional bonds as long as the new debt would not increase the State's annual principal and interest payments by more than the following amounts: \$34.771 million in total for all institution bonds, \$16.222 million for highway bonds, \$52.374 million for general obligation bonds, excluding institution and highway bonds, and \$15.689 million for economic development bonds. (*Institution bonds* are general obligation bonds that benefit the State's Higher Education Fund.)

#### **Economic Factors and Next Year's Budget**

#### The "Rainy Day Account"

At June 30, 2005, the General Reserve Fund, sometimes called the *rainy day account*, had a balance of \$75.155 million rather than the \$153.488 million needed to be fully funded at that date. The State's Constitution requires restoration of the reserve to full funding within three years after a withdrawal. State law defines full funding for the reserve as 3% of the Budgetary General Fund's revenues for the latest completed accounting year. The 2005-2006 Appropriation Act passed by the General Assembly appropriated \$78.333 million to fully restore the rainy day account. These funds were transferred in September 2005 to fully fund the General Reserve Fund.

#### **Budgetary General Fund for the 2005-2006 Accounting Year**

For fiscal year 2005-2006, estimated revenues per the Appropriation Act were \$5.966 billion, or 0.7% *less* than current year actual revenues. This estimate was subsequently revised. On November 10, 2005, based on most recent revenue collection trends, the State's Board of Economic Advisors (BEA) revised its original revenue estimate for fiscal year 2005-2006 upward by \$275.667 million, or 4.6%, to a total of \$6.242 billion. This represents a 3.9% increase over actual revenues for fiscal year 2004-2005.

See the *Budgetary General Fund Highlights* subsection above for additional information about the responsibilities of the BEA and the State Budget and Control Board.

#### **Economic Conditions**

Despite the State's high unemployment rate, Budgetary General Fund revenues for the first four months of the 2005-2006 fiscal year were \$143.481 million, or 7.9%, higher than fiscal year 2004-2005. South Carolina's three major revenue sources are experiencing significant gains, reinforcing the fact that economic conditions are improving in the State. Individual income taxes are up 9.5%, as withholdings increased 9.4% and estimated tax payments increased 19.8%. Corporate income taxes have grown by 9.9%. Sales taxes have increased 7.4% despite higher gasoline prices.

The BEA has adopted a preliminary Budgetary General Fund revenue estimate of \$6.433 billion for the 2006-2007 accounting year. This revenue forecast represents a 3.1% increase over the revised base for 2005-2006. The BEA will review this estimate again in February 2006 and either adjust or finalize it then.

#### **Requests For Information**

The primary purpose of this financial report is to provide South Carolina's citizens, taxpayers, customers, investors, and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. Please address your questions concerning information in this report to:

Office of the Comptroller General 1200 Senate Street 305 Wade Hampton Office Building Columbia, South Carolina 29201